Creditworthiness and Risk Analysis in the “New World”

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Credit & Counterparty Risk

What is Credit Risk?

- Credit Risk is the degree of uncertainty of one counterparty's ability to fulfill its contractual obligations toward another.

- Credit exposure refers to the losses that could occur to one counterparty if another counterparty were to default in the future.

Migration of Credit Risk

- Historically, credit risk was low. Utility credit ratings averaged at the ‘A-’ to ‘BBB+’ level, everyone was investment grade
- Deregulation brought new participants to the market
- The California energy crisis and Enron’s implosion severely impacted the credit markets
- U.S. transition to competitive wholesale power markets has stalled
- Traditional practice of assigning open credit is no longer prudent--collateral is now required

Credit Quality is under Pressure

- Existence of very large regional reserve margins stemming from a 2-year power plant construction boom
- Resulted in lower power prices and diminished trading liquidity
- Shrinkage of trading business, lower levels of cash flow
- Diminished liquidity and financial flexibility
- Downgrades and demands for security
- Bankruptcy, investigations and regulatory difficulties
- Corporate reaction—restructuring, asset sales and the exit of some markets

What Does the Future Bring?

- Credit Quality is likely to remain under pressure for the next year
- Expect deregulation, or as it should be properly called, *restructuring*, to forge ahead
- “It is easier to let the cat out of the bag than to put it back in...”

FERC’s Resolve

- Orders 888 and 889 opened the way for competitive wholesale power
- Order 2000 continued restructuring by encouraging the transition of 140 control areas to the development of 4 to 5 RTO’s
- US Supreme Court strengthened FERC’s resolve by affirming open access to IPP’s
- Standardized wholesale market design will be next

Standardized Market Design

FERC is proposing to establish a single tariff for all transmission service and a single set of standard rules to be applied to transmission operators and wholesale electricity markets by independent transmission providers on all transmission systems throughout the U.S.

Credit Risk Considerations

- Nonprice allocation of capacity creates congestion during peak times
- Systems that manage congestion hide price signals that tell investors where to build generation and transmission assets
- Market congestion is contributing to illiquid markets--hindering efficiency
- Adjoining regions may impede trade and introduce economic inefficiencies

Exchanges & Clearinghouses

- Exchanges - are marketplaces where members make markets in listed products because they help create price discovery and transparency (*Intercontinental Exchange, TradeSpark*)
- Clearinghouses – reviews the terms of each trade and assures performance to both sides of a transaction (*NYMEX, BOTCC*)
- A combination of both or blending – could enhance credit quality

New World Example of Credit

- Structure
- Operation
- Liquidity and Credit Quality
- Working Capital requirements
- Bilateral terms
- Major departure from the status quo

What is TVA Doing?

- Management identified these trends and established a policy to deal more effectively with credit risk
- Enterprise credit risk approach
- Shift to “Proactive” from “Reactive” risk management
- New contract credit language
- Creditworthiness assessment and analysis
- Credit assurance
- Manage credit exposure and monitor counterparty creditworthiness

Closing

"Market values are fixed only in part by balance sheets and income statements; much more by the hopes and fears of humanity; by greed, ambition, acts of God, invention, financial stress and strain, weather, discovery, fashion and numberless other causes impossible to be listed without omission".

--Gerald M. Loeb, *The Battle for Investment Survival* (1996)